Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:BOS:TL-N-6900-00
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date: April 4, 2001

to: Territory Manager, LMSB - Natural Resources
Attn: [redacted], Acting Case Manager

from: Area Counsel (LMSB), Area 1, Financial Services & Healthcare

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subject: [redacted]
IRC § 163(j)

This memorandum refers to your request for advice concerning the application of IRC § 163(j) to transactions involving taxpayer [redacted]. This memorandum should not be cited as precedent.

ISSUES

1. Whether the documents provided concerning the participation of the foreign parent in a credit agreement constitute a guarantee of loans to the U.S. subsidiary taxpayer, thus triggering the application of the rules for the limitation of deduction for interest under I.R.C. § 163(j).

2. Whether the proposed regulations promulgated under I.R.C. §163(j) should be used in calculating adjusted taxable income as defined in I.R.C. § 163(j)(6)(A).

CONCLUSION

1. It is our opinion that the documents provided, in and of themselves, are not sufficient to constitute a guarantee resulting in the application of the disqualified interest rules pursuant to I.R.C. § 163(j)(3)(B)(i).

2. If additional documents were uncovered to support a determination that a guarantee, pursuant to section 163(j), had been provided by the parent, we would recommend that the adjusted taxable income be calculated in two ways: (1) relying on the provisions of I.R.C. § 163 itself, and (2) relying both on the Code and the Temporary Regulations promulgated under I.R.C. § 163.

FACTS

The facts as set forth below, and upon which this advice is based, are as understood based upon information provided by your office. If our understanding of the facts is not correct, or if the facts have changed in any way, you should not rely on this advice, but rather seek modified advice based on the changed circumstances.

Taxpayer, [redacted], was founded in [redacted] and was acquired by [redacted] in [redacted]. On [redacted], [redacted], a wholly owned subsidiary of [redacted] acquired from [redacted] all of the outstanding capital stock of [redacted], then a wholly owned subsidiary of [redacted], and certain related affiliates of [redacted]. Immediately following the acquisition, [redacted] merged with and into [redacted], with [redacted] surviving. In [redacted], [redacted] acquired [redacted]. [redacted] is an indirect, majority owned ([redacted]%) subsidiary of [redacted].

[redacted] and has [redacted] and [redacted] operations vertically integrated with certain of its manufacturing facilities. [redacted] is the [redacted] producer of [redacted] in the United States, and currently operates [redacted] with total annual production capacity of approximately [redacted] of [redacted] and [redacted] of [redacted]. [redacted] also operates a [redacted] and distribution facility in [redacted], [redacted] with annual [redacted] capacity of approximately [redacted], and owns approximately [redacted] of [redacted] in the State of [redacted].

Established in [redacted], [redacted] is a [redacted] products group with manufacturing facilities on [redacted] and an international sales network that markets the Group's products in over [redacted] countries. Shares of [redacted] are listed on the [redacted], [redacted], [redacted] exchanges and American Depository Receipts on the New York Stock Exchange.

The [redacted] is segmented into three functional business units: (1) [redacted], which was formed on [redacted] by the integration of [redacted]'s [redacted] international [redacted] operations ([redacted] and [redacted] in [redacted]) and is headquartered in [redacted], [redacted], manages the Group's [redacted] and related [redacted] business in [redacted], [redacted], (2) [redacted], based in [redacted], produces [redacted] products ([redacted] and

[redacted]), [redacted] (including [redacted] and [redacted]) for [redacted] and export markets, and (3) [redacted], based in [redacted], operates a trading network for the international marketing and distribution of the Group's products outside the Group's core operation regions of [redacted].

As part of your examination of [redacted], you looked at the acquisition of [redacted] Company and its subsidiaries ([redacted] by [redacted] ([redacted]), and, in doing so you discovered a loan document prepared by [redacted] with respect to a [redacted] bond project which, on page [redacted], under the heading "[redacted]" described the [redacted] merger of [redacted] into [redacted], and the related credit agreement, as follows:

> On [redacted], the [redacted] and [redacted]. (together "[redacted]") signed a commitment letter pursuant to which, on [redacted], the aforementioned parties entered into the Credit Agreement pursuant to which the company [redacted] is entitled to borrow up to an aggregate principal amount of $[redacted]. The loan facilities were arranged by [redacted] and consist of (i) the Term Loan Facilities, consisting of a [redacted]-year senior secured term loan facility in an aggregate principal amount of $[redacted] (the "[redacted] Term Loan"), and an [redacted]-year senior secured term loan facility in an aggregate principal amount of $[redacted] (the "[redacted] Term Loan"), (ii) the Revolving Credit Facility and (iii) the Letter of Credit Facility. The
>
> [redacted].

Based upon this information, you issued an Information Document Request (IDR#[redacted]) asking [redacted] to "[p]rovide a copy, including all schedules, attachments, exhibits and/or annex, of the signed commitment letter dated [redacted] between [redacted], the [redacted] and [redacted]."

In response to your request, [redacted] provided a letter, dated [redacted], in which the current chief financial officer of [redacted], who, just prior to the subject acquisition held the title Financial Director, [redacted], stated that he was [redacted] which went on to describe in more detail as follows:

> . . . [redacted] was chosen as the lead bank in a consortium of lenders who made capital available for the purchase. Pursuant to the terms of the Credit Facility, all bank lending was collateralized by the assets of [redacted] and its immediate parent, [redacted]. These assets represented the only source of assurance provided by [redacted] or [redacted] to the [redacted]. In the event of a default under the Credit Agreement, the [redacted] would have had the right to enforce their security interest in the stock of [redacted] and [redacted]'s assets. However, neither [redacted] nor any of its other subsidiaries agreed, pursuant to the terms of the loan documents or any side agreements including so called "comfort letters", to stand behind or otherwise assure the payment of [redacted]'s obligations to the [redacted]. From a strategic business perspective, [redacted] owned valuable assets in [redacted], the [redacted] and [redacted] at the time of the acquisition. It was not [redacted]'s intention to put these assets as risk in making the [redacted] acquisition. From a legal perspective, [redacted] did not expect the [redacted] to be able to look to [redacted] for payment in the event of a [redacted] default.

[redacted]

[redacted].

After further request, [redacted] provided a copy of the [redacted] and [redacted] which, according to page 6 of the [redacted], replaced "the [redacted] and [redacted] dated [redacted]." You do not have a copy of the [redacted] letter.

The [redacted] begins with the following understanding by [redacted] ("[redacted]"):

> . . .that a newly-formed corporation (the "[redacted]") to be organized by [redacted], Limited or one or more of its affiliates (collectively, "[redacted]"), [redacted]., and certain of its affiliates (collectively, "[redacted]"), and [redacted] and certain of its affiliates (collectively, "[redacted]"; [redacted] amd [redacted], collectively, the "Investors"), proposes to acquire (the "Acquisition") from [redacted] ("[redacted]") all of the outstanding capital stock of [redacted], a [redacted] corporation ("[redacted]") for a purchase price (including transaction fees and expenses and the refinancing of certain liabilities, the "Purchase Price"), of approximately $[redacted]. . . .

On page [redacted] of the [redacted],

> . . . as consideration for [redacted]'s commitment hereunder and for the agreements of [redacted] and [redacted] contained herein as to the management, structuring and syndication of the [redacted], each Investor severally, ratably in proportion to the aggregate amount paid or contemplated to be paid for the common and preferred equity of the Borrower and the U.S. Parent on the date of the Acquisition, agrees to pay the fees set forth in the [redacted] dated the date hereof (the "[redacted]").

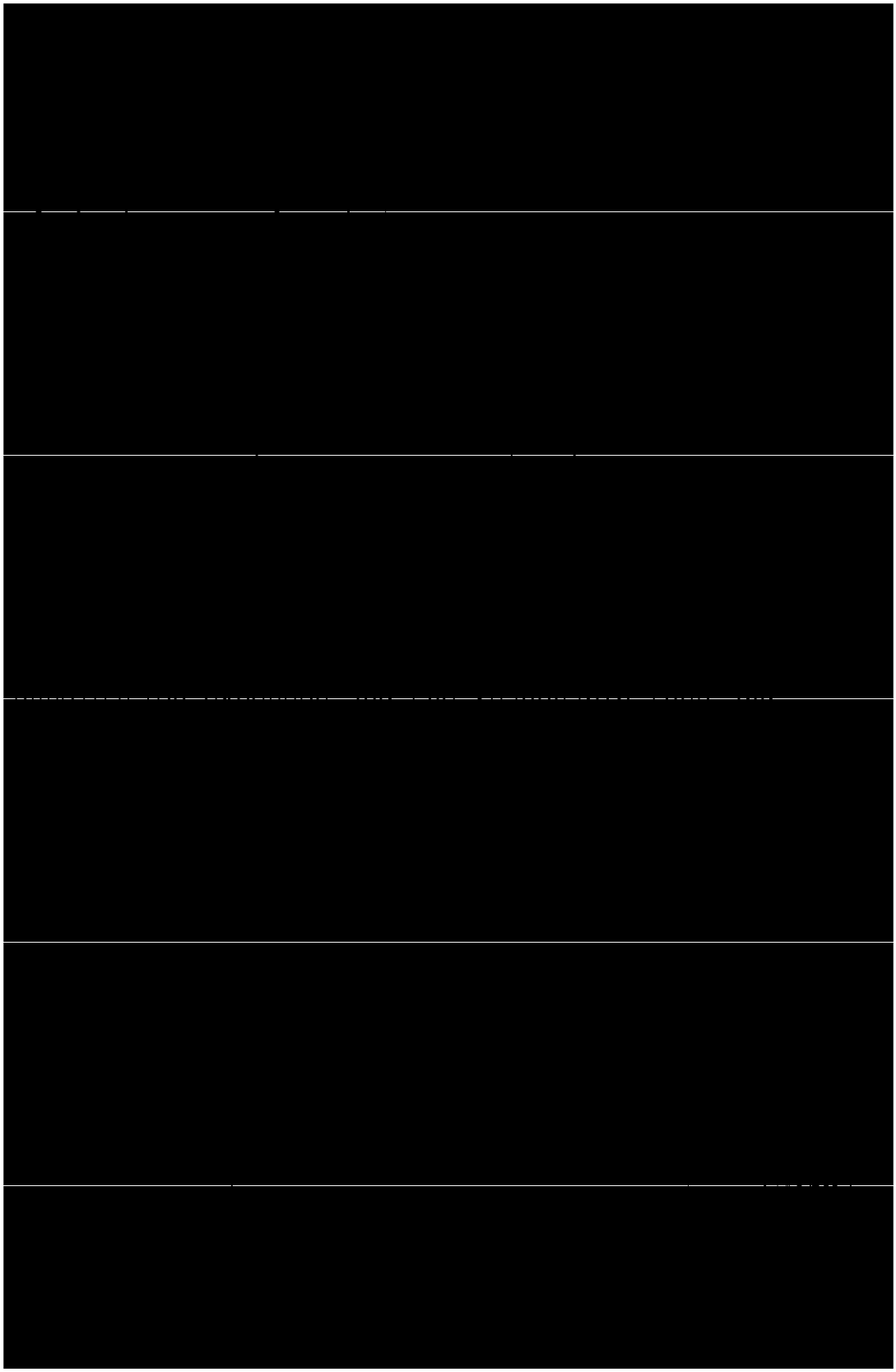
On page [redacted], [redacted]'s commitment is made subject to the following conditions, among others:

[redacted]

[redacted]

The [redacted] further provides that by executing the letter:

[redacted]



[redacted]

The Commitment Letter was signed by the Vice President of [redacted], the Managing Director of [redacted], the Director of [redacted], [redacted], the Managing General Partner of [redacted], and both the Managing Director and the President of [redacted].

The [redacted], also dated [redacted] and attached to the [redacted], under Section [redacted], entitled "[redacted]" identifies the borrowers as follows:

> "A newly-formed corporation ("[redacted]") to be organized by [redacted], limited or one or more of its affiliates (collectively, "[redacted]"), [redacted]. and certain of its affiliates (collectively, "[redacted]"), and [redacted] and certain of its affiliates (collectively, "[redacted]": together with [redacted] and [redacted], the "Investors"), and, after the proposed merger of [redacted]. with [redacted] ("[redacted]"), the surviving corporation of such merger (the "Borrower").

Under Section [redacted], of the [redacted], entitled "Guarantees and Collateral,"Guarantees" are described as follows:

> "All obligations of the Borrower under the financing agreements contemplated hereby will be unconditionally guaranteed by the direct parent of the Borrower (the "U.S. Parent") and each of the Borrower's direct and indirect domestic subsidiaries."

In the same section "Collateral" is described as follows:

[redacted]

Under [redacted] Certain Covenants and Events of Default events of default are described as follows:

> Usual for facilities and transactions of this type and others reasonably specified by the Lenders, including, without limitation (subject to customary grace periods when appropriate), nonpayment of principal, interest, fees or other amounts, violation of covenants, material inaccuracy of representations and warranties, cross-default, bankruptcy, material judgments, ERISA, actual or asserted invalidity of any loan documents, security interest or subordination provisions, or failure of [redacted] to beneficially own at least [redacted]% of the capital stock of the Borrower or have the right to appoint a majority of the board of directors of the Borrower.

You have requested our advice as to whether, under the described circumstances, the rules for the limitation of deduction for interest under I.R.C. § 163(j) would apply and, if so, how adjusted taxable income should be calculated.

LEGAL ANALYSIS

I.R.C. § 163(j) limits the deductibility of interest paid or accrued by U.S. and certain foreign corporations to related persons in situations where all or a portion of such interest is exempt from U.S. taxes. In addition, for taxable years beginning after 1993, section 163(j) limits the deductibility of interest paid or accrued by U.S. or certain foreign corporations to unrelated persons in the same manner as interest paid to a related person if the debt is guaranteed by a related person and other conditions are met.

Generally, a disqualified guarantee is one made by a related tax-exempt organization or a related foreign person. Thus, loans guaranteed by U.S. corporations are not subject to section 163(j). Section 163(j)(6)(D)(iii) defines guarantee broadly to include "any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness." The legislative history states explicitly that "guarantee" is to include any form of credit support by a related party:

> . . . This includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. It includes an arrangement reflected in a "comfort letter," regardless whether the arrangement gives rise to a legally enforceable obligation. If a guarantee is contingent upon the occurrence of an event, the provision would apply as if the event had occurred.

House Report No. 103-11, 103d Cong., 1st Sess. 249 (WCMP, 1993) (1993,House Report).

Similarly, the Senate Report describes a zero tolerance for an expression of willingness on behalf of a foreign entity to support a related party debtor, whether or not through a legal binding obligation:

> The Committee intends that the term [guarantee] be interpreted broadly enough to encompass any form of credit support. This includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. It includes an arrangement reflected in a "comfort letter," regardless of whether the arrangement gives rise to a legally

> enforceable obligation. If the guarantee is contingent upon the occurrence of an event, the provision would apply as if the event had occurred.

Committee on the Budget, U.S. Senate Reconciliation Submissions of the Instructed Committees Pursuant to the Concurrent Resolution on the Budget, 103d Cong., 1st Sess., S. Prt. 103-36, 372 (June 1993), at 317.

Although section 163 (j)(6)(D)(iii) anticipates further guidance by regulation, the proposed regulations promulgated under section 163 include no such guidance with respect to the definition of "guarantee."

It is our opinion that the documents provided, in and of themselves, are not sufficient to constitute a guarantee resulting in the application of the disqualified interest rules pursuant to I.R.C. § 163(j)(3)(B)(i). We note that in the commitment letter the investors as a condition precedent to [redacted] providing the loan the Investors stated that they would invest a total of $[redacted] in the form of common stock and preferred stock in the borrower and its US parent. We have no information as to whether such investments were actually made. If the amounts stated were not invested in the borrower and the US Parent, the obligation to invest would constitute a guarantee (until the time the investment was actually made). You may wish to verify the payment of those amounts.

A corporation is subject to I.R.C. § 163(j) only to the extent it generates excess interest expense in a given year. "Excess interest expense" is generally the corporation's net interest expense in excess of 50% of the corporations's adjustment taxable income. "Adjusted taxable income" is defined in I.R.C. § 163(j)(6)(A) as the taxpayer's taxable income computed without regard to its net interest expense, net operating loss deductions and cost recovery deductions such as depreciation, amortization or depletion. Prop. Regs. § 1.163(j)-2(f) also requires adding back, among other items, charitable contributions carried over from prior years, tax-exempt interest income, dividends-received deductions and capital losses carried forward or back. Required subtractions include interest expense related to tax-exempt income, current year limited charitable contributions and current year net capital losses. Thus, as adjusted taxable income increases, so too does the minimum threshold for imposition of the earnings stripping deferral.

With respect to the calculation of the debt-to-equity ratio, assets and liabilities should be computed under tax, not accounting, concepts, as stated specifically in the Proposed Regulations, Prop. Reg. § 1.163(j)-3, and also, in the legislative history with respect to I.R.C. § 163(j) itself.

Regulations that relate to statutory provisions enacted before July 30, 1996, generally applied retroactively to the effective date of the underlying legislation. I.R.C. § 7805(b), prior to amendment by P.L. 104-168, 104th cong., 2d Sess., § 1101(a) (July 30, 1996). A temporary, proposed or final regulation relating to statutory provisions enacted on or after July 30, 1996, however, may not apply retroactively to a period ending before the date on which the regulation or related proposed or temporary regulation was filed with the Federal Register, or the issuance date of a notice that substantially described the expected contents of any temporary, proposed or final regulation. I.R.C. § 7805(b)(1). Congress has indicated that it is generally inappropriate for the Service to issue retroactive regulations. HR Rep. NO. 506, 104th cong., 2d Sess.(1996). The section 163 proposed regulations were published in the Federal Register on July 13, 1991, and, thus, could be applied to the [redacted] and [redacted] taxable years here at issue. (b)(5)(passage of a decade however, makes it unlikely that the proposed

(b)(5)(DP)

(b)(5)(DP) .

We note that the Tax Court has held that proposed regulations "carry no more weight than a position advanced on brief by the respondent." *Miller v. Commissioner*, 70 T.C. 448, 460 (1978), quoting *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970). Accordingly, the Tax Court has declined to refer, over a Petitioner's objection, to proposed regulations in deciding an issue. *Greene v. Commissioner*, T.C. Memo 1998-331.

(b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC), (b)(5)(AWP)

(b)(5)(AC)

[redacted]

Since there appears to be no further action to be taken by our office at this time we have marked our file closed. There are no administrative files to be returned to your office. If there are any questions, or if you wish us to review additional documents, may contact the undersigned at (617)565-7914.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views

DAVID BRODSKY
Associate Area Counsel
(Large and Mid-Size Business)

By:_____
MARVIS A. KNOSPE
Attorney (LMSB)

cc: Roland Barral, Area 1 Counsel (LMSB) Nancy
Nancy Knapp, Area 1 Senior Legal Counsel (LMSB)